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In the Supreme Court of the United States

October Term, 1933

No. 187

ARTHUR M. BROWN, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 54–69) is reported in 22 B.T.A. 678. The opinion of the Circuit Court of Appeals (R. 274–281) is reported in 63 F. (2d) 66.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered February 6, 1933 (R. 282–283). A petition for rehearing was denied March 21, 1933 (R. 283). The petition for a writ of certiorari was

filed June 19, 1933. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether a payment of $3,000 made by the petitioner to his sister in 1923, pursuant to the terms of a modified agreement originally executed in 1902, was deductible from income as a business expense or otherwise.

2. Whether the Board of Tax Appeals and the court below erred in holding that the petitioner, accounting on the accrual basis, was obliged to report the full amount of the so-called overriding commissions received in 1923, 1925, and 1926, without deduction, either as a reserve or otherwise, on account of a contingent liability to refund certain portions of such overriding commissions in later years on account of cancellation or reinsurance.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 14–15.

STATEMENT

The findings of fact made by the Board of Tax Appeals (R. 56–63) are not controverted and may be summarized as follows:

From 1896 to 1904 the petitioner, an individual residing in California, together with his father, Edward Brown, and his brother Herbert H. Brown,

was engaged in business as a general insurance agency. After the death of the father in 1904 and until 1922 the business was carried on by the petitioner and his brother. The latter died in 1922 and the business was thereafter conducted by the petitioner alone until January 1, 1924, when the petitioner's son Arthur M. Brown, Jr., was admitted as a partner. This relationship continued throughout the taxable years 1925 and 1926. The business was at all times carried on under the name Edward Brown & Sons (R. 56).

On June 1, 1902, the father and sons entered into a written agreement as to their respective interests in the business and providing (R. 56, 57):

> Before any division of profits is made the said partners mutually agree to pay monthly to Jesse H. Jones, Edith H. Halton and Ethel Brown, (the three daughters of Edward Brown and Sisters of Arthur M. Brown and Herbert H. Brown), the sum of Two Hundred and Fifty Dollars ($250.00) and Further, that whenever the net income from the business of the said firm shall exceed the sum of Eighteen Thousand Dollars per annum they will pay a one-sixth proportion of such excess to the said Jessie H. Jones, Edith H. Halton, and Ethel Brown.

On May 27, 1905, a written agreement was executed between the surviving members of the partnership, the executor of the estate of Edward Brown, and the three daughters of the decedent.

This agreement was apparently lost and no proof of its contents was made (R. 58).

On May 28, 1907, the two surviving daughters of Edward Brown executed a written agreement whereby they agreed to accept from the firm the sum of $250 per month beginning June 1, 1907, and ending only by mutual agreement "in full satisfaction for all amounts which may be due, or may become due, to us, or either of us, or to the survivor of us," under the agreement dated May 27, 1905 (R. 59). This instrument provided that any further amounts to which the surviving daughters might become entitled should be retained in the net profits of the firm as the property of the petitioner and his brother.

This agreement was never modified. In 1923 the petitioner made a payment of $3,000 to his sister Edith H. Halton, in accordance with the terms of the agreement and claimed the same as a deduction in his return for that year. The deduction was disallowed by the Commissioner on the ground that the payment constituted a capital expenditure (R. 60).

During the years in question the firm of Edward Brown & Sons acted as general agents in a number of western States and Federal territories for six fire insurance companies. The firm's relationship with certain of these companies was fixed by oral conversations with their officers and with other of the companies by written agreements (R. 60).

The duties performed by the firm were substantially the same for all six companies. The firm appointed and removed local agents; accepted service of process; adjusted losses under policies; issued, countersigned, and cancelled policies; received and receipted for premiums; surveyed and accepted or rejected risks; represented its principals on the local Board of Fire Underwriters; rendered all reports required of its principals by local authorities; paid the necessary license fees and taxes and "generally attended to all of the affairs of its principals in the territory in which it operated" (R. 60–61).

The firm received as its compensation, in addition to a percentage of the net profits on business written in its territory, so-called "overriding commissions," which are stated percentages of the net premiums written (R. 61).

All policies written by the firm since 1917 were for periods of one, three, or five years. These policies were subject to cancellation. If the insurance company cancelled, it was obligated to refund a ratable proportion of the premium for the unexpired term of the policy; if the assured cancelled, the company was entitled to retain the customary short-period rate for the time the policy continued in force (R. 61–62).

The firm made remittances to its principals on monthly balances, crediting itself, among other things, with the overriding commissions due on the

business written during the month and charging itself, among other things, with a proportional part of any overriding commissions previously received in respect of any business which was cancelled or reinsured in another company during the month.

The books of the firm show the gross premiums written and the premiums cancelled resulting in a percentage of cancellation approximating 22 per cent, based upon five-year periods from 1919–1923 to 1922–1926 (R. 62).

The books of account were kept on the accrual basis. Overriding commissions on new business were accounted income of the year in which the business was written and refunds of overriding commissions on account of cancellations or reinsurance were accounted expense of the year of cancellation or reinsurance (R. 63).

At the close of 1923, for the first time, a liability account denominated "Return Commissions" was set up on the firm's books. This was for the purpose of recording the firm's contingent liability to refund to insurance companies a portion of the overriding commissions received during the year on account of future cancellations and the reinsurance of business written during the year. At the close of each of the years 1924 to 1926, inclusive, the credit balance in the account was adjusted to reflect the same proportion of the overriding commissions received during the year as the total fire premiums cancelled in the next five-

year period bear to the gross fire premiums written in the same period (R. 63).

The petitioner claimed as a deduction for 1923 the amount credited to the contingent liability account at the close of that year. Similar deductions were claimed in respect of partnership net income for 1925 and 1926. All three deductions were disallowed by the Commissioner. The Board of Tax Appeals approved the action of the respondent, both with respect to the disallowance of the payment to Mrs. Halton and also with respect to the disallowance of the deductions on account of anticipated refunds of overriding commissions resulting from cancellation and reinsurance. The Circuit Court of Appeals affirmed the decision of the Board.

ARGUMENT

I

THE DISTRIBUTION TO THE PETITIONER'S SISTER

The Commissioner disallowed the deduction of the payment of $3,000 made to the petitioner's sister, Mrs. Halton, in 1923, on the ground that it was a capital expenditure. The Board of Tax Appeals and the court below found it unnecessary to pass upon the precise nature of the transaction, but held that it was not shown to be a deductible business expense. In this we submit that they were clearly right.

The petitioner urges that the payment to his sister may be "subtracted" in computing taxable

income (Pet. 4). But the petitioner has at no time indicated upon what theory he claims the deduction. From the fact that he relies upon an alleged conflict with the decision in *Commissioner* v. *Olds*, 60 F. (2d) 252 (C.C.A. 6th), it may be inferred that he would have the payment regarded as a distribution in partnership. The analogy of the two cases is far from evident. In the *Olds case* the Board of Tax Appeals found as a fact (15 B.T.A. 560) that a *bona fide* partnership existed of which the recipients of the distributions were members. The Circuit Court of Appeals accepted this finding as correct and it thereby became conclusive. *Texas & N. O. R. Co.* v. *Ry. Clerks*, 281 U.S. 548, 558. Here, on the contrary, the petitioner never claimed the existence of a partnership with his sister; the Board made no finding to that effect, and the entire record squarely negatives the existence of such a relationship.

The petitioner wholly failed to carry the burden of affirmatively establishing his right to the deduction before the Board, and the court below had no alternative but to affirm the action of the Board in disallowing it.

The petitioner suggests (Br. 37) that corresponding distributions were allowed as deductions in 1925 and 1926. Upon this premise he contends that two determinations were made by the Commissioner, one at variance with the other, and the later must prevail (Br. 36–37). We have found

nothing in the record to support the assumption relating to the treatment of corresponding items in 1925 and 1926. Even if this assumption is correct there may well have been other considerations or different evidence adduced in the later years.

II

THE OVERRIDING COMMISSIONS

The principal issue relates to the proper treatment of the so-called "overriding commission," which were stated percentages of the net premiums written. The policies of insurance were written upon the basis of one-, three-, and five-year periods. In the event of cancellation or reinsurance during the life of a given policy the petitioner was obliged to return a portion of the commission which was received when it was written.

The firm consistently accounted for overriding commissions on new business as income of the year in which the business was written. A change in this method of treatment could only be justified on the ground that net income would be more clearly reflected. It is submitted there is no such justification. The petitioner suggests (Br. 31) that the method for which he contends "as a matter of fact, will just as truly reflect an income." This is not enough—particularly so inasmuch as there is an inevitable duplication of deductions during the year of change. See the concurring opinion of Judge Wilbur, R. 280–281.

The petitioner places much emphasis upon the fact that the business was operated on the accrual basis. But this is not enough to authorize the deduction of contingent liabilities. The fact remains that the petitioner received, subject to his absolute disposition, the full amount of the overriding commissions during each of the taxable years, subject only to a possibility that he would have to refund the same or a portion thereof in later years. When such a liability actually arises the taxpayer is entitled to deduct the amount actually repaid. Such a deduction was allowed the petitioner here. But we know of no authority for the deduction of such amounts by means of a reserve before the liability has in fact arisen.

Congress has provided specifically for the allowance of reserves in certain instances, notably in the case of bad debts and certain statutory reserves of insurance companies. The right to the use of such reserves in the case of bad debts is a matter confided to the discretion of the Commissioner.[1]

[1] Section 214 (a) (7) of the Revenue Acts of 1921, 1924, and 1926 provides:

> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the commissioner, a reasonable addition to a reserve for bad debts); * * * (U.S.C. and U.S.C. App., Title 26, Sec. 955.)

The very fact that it was deemed necessary to incorporate these specific provisions in the statutes indicates that in their absence there would have been no right to secure deduction on account of reserves. The petitioner does not claim to come within any statutory reserve.

Whatever doubt may have existed with respect to the deduction of reserves not sanctioned by statute would seem to have been set at rest by the decision of this Court in *Lucas* v. *American Code Co.*, 280 U.S. 445. This Court there said (p. 452):

> The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions. The reserve set up by the Company was of that character. It cannot be said that the loss actually paid by the Company in 1923 was, as a matter of law or of undeniable fact, sustained in 1919.

The petitioner alleges conflict (Pet. 19–20) with a number of decisions of this and other courts. The cases of *United States* v. *Anderson*, 269 U.S. 422, and *American National Co.* v. *United States*, 274 U.S. 99, are distinguished in the later decision of this Court in *Lucas* v. *American Code Co., supra*. The munitions tax involved in the *Anderson case* and the loan bonuses in the *American National Co. case* were fixed and enforceable liabilities within

the taxable year. Most of the other cases relied on by the petitioner seem similarly distinguishable.

The decision in *Virginia-Lincoln Furniture Corp.* v. *Commissioner,* 56 F. (2d) 1028 (C.C.A. 4th), comes nearest to creating a conflict of any of the cases cited by the petitioner. The court there permitted the deduction of a reserve not sanctioned by statute. The decision is believed to be at variance with the principles announced by this Court in *Lucas* v. *American Code Co., supra.* In any event there are certain significant fact differences. In the present case, the "overriding commissions" were based on the gross premiums *received* during the year less premiums actually returned whether on business written during the year or written in prior years. Otherwise the determination of the year's "net premiums written" could not be made until every policy written during that year had expired, perhaps five years later. In the *Virginia-Lincoln case* the gross income consisting of the sale price of furniture was not actually *received* when the sale was consummated. It was not a case, like the present, of a taxpayer who has actually received money subject to his absolute disposition and seeks relief from taxation because of a contingent future liability to refund. This aspect of the present case distinguishes it from every case relied upon by the petitioner.

CONCLUSION

We submit that the decision of the court below is correct. There is no conflict and the petition should be denied.

Respectfully submitted.

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JULY 1933.

APPENDIX

Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or

> gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; * * *.

Sections 212 (b) and 213 (a) of the Revenue Acts of 1924, c. 234, 43 Stat. 253 (U.S.C., Title 26, Secs. 953, 954), and 1926, c. 27, 44 Stat. 9 (U.S.C. App., Title 26, Secs. 953, 954), repeat the language of the corresponding sections of the Revenue Act of 1921.

Treasury Regulations 62, promulgated under the Revenue Act of 1921:

> ART. 32. *Compensation for personal services.*— * * * Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, * * * are income to the recipients; * * *.
>
> ART. 36. *Long-term contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. * * *

These provisions were carried over to the corresponding numbered articles of Treasury Regulations 65 and 69, promulgated under the Revenue Acts of 1924 and 1926, respectively.

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